

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Thomson Analyst: Kristina E. North Bill Number: AB 2514
Related Bills: See Legislative History Telephone: 845-6978 Amended Date: June 26, 2000
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Rice Straw Credit/Increases Credit & Deletes Repeal Date/Rice Straw Storage Structure Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would indefinitely extend the rice straw credit; increase the credit amount and the aggregate credit limit; allow the credit to be sold or otherwise transferred by the taxpayer to any other taxpayer; and delete the requirement that the taxpayer may not be related to any person growing the rice straw for which the credit is claimed.

Under the PITL and the B&CTL, this bill would create a new tax credit in the amount of 50% of a taxpayer's cost for the construction of storage structures to house rice straw grown in California and purchased by the taxpayer.

These credits are discussed separately in this analysis.

This analysis does not address the bill's changes to the Health and Safety Code, as they do not impact the department.

SUMMARY OF AMENDMENTS

The June 26, 2000, amendment reinstated the PITL language prohibiting the rice straw from being burned. The amendment also changed the rice straw storage credit to extend the number of years that the storage facility must be used for storing rice straw or rice straw harvesting or processing equipment from five years to ten and added a recapture provision.

The June 14, 2000, amendment made a number of changes to the rice straw credit, including inadvertently deleting the PITL language prohibiting the rice straw from being burned and adding the rice straw storage structure credit to the bill.

The June 12, 2000, amendment added the rice straw credit to the bill and deleted its repeal date, extending the credit indefinitely.

This is the department's first analysis of this bill.

EFFECTIVE DATE

This bill would be effective January 1, 2001, and operative for taxable or income years beginning on or after January 1, 2001, with the rice straw storage credit operative until taxable or income years beginning on or after January 1, 2006.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

Gerald H. Goldberg

8/1/00

LEGISLATIVE HISTORY

AB 510 (Stats. 1998, Ch. 49) made a nonsubstantive, technical change relating to partnerships in the rice straw credit.

SB 38 (Stats. 1996, Ch. 954) created a tax credit equal to \$15 for each ton of rice straw purchased by the taxpayer.

SB 2086 (1996) would have done the same but failed passage in the Assembly.

SPECIFIC FINDINGS

Federal law and state laws contains a variety of provisions specifically relating to farmers and agriculture. These provisions include special accounting and inventory methods, certain income deferral conditions, capital gain/ordinary loss treatment, the deduction of items normally capitalized, and exempt status for labor, agricultural, or horticultural organizations.

Current federal and state laws provide various tax credits that are designed to provide tax relief for taxpayers who incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits, enterprise zone, or program area hiring credits). These credits provide incentives for businesses to perform actions that they may not otherwise do, may not do at the desired location, etc.

Current state law allows a tax credit equal to \$15 for each ton of rice straw purchased by the taxpayer that was grown in California. Under both the PITL and the B&CTL, the credit is limited to an aggregate annual amount of \$400,000. By reference to the Health and Safety Code, "rice straw" is defined as the dry stems of cereal grains left after the seed heads have been removed. The purchaser must be the "end user" of the rice straw (i.e., anyone who uses the rice straw for processing, generation of energy, manufacturing, export, prevention of erosion, or for any other purpose, except open burning, which consumes the rice straw). Also, the taxpayer allowed the credit cannot be related to the person who grew the rice straw. The credit is available for taxable and income years beginning on or after January 1, 1997, and before January 1, 2008. This credit is in lieu of any other credit or deduction allowed for the purchase of the rice straw used to claim the credit. Any excess credit may be carried over for 10 years or until exhausted, whichever occurs first.

Current state law requires the Department of Food and Agriculture to certify the taxpayer's purchase of the rice straw and the amount of the credit and provide the taxpayer with a copy; issue the certificates on a "first come, first served basis"; provide an annual listing to the Franchise Tax Board (FTB) with the taxpayer's identification number(s); and provide an annual report to the Legislature. To qualify for the credit, the taxpayer must provide the Department of Food and Agriculture with verification that the purchase of rice straw meets the requirements of this section; retain a copy of the certification provided by the Department of Food and Agriculture and provide a copy of it to this department upon request; and provide the Department of Food and Agriculture with the taxpayer identification number or all partners' or shareholders' numbers in the case of a partnership or S corporation.

RICE STRAW CREDIT

This bill would:

- ?? permanently authorize the credit by deleting the rice straw credit repeal date of January 1, 2008;
- ?? increase the credit amount from \$15 to \$20 per ton;
- ?? increase the aggregate credit limit from \$400,000 for each calendar year to \$14.5 million for each taxable or income year beginning on or after January 1, 2001, and before January 1, 2006. After January 1, 2006, the aggregate credit limit would increase to \$16 million for each taxable or income year;
- ?? allow the credit to be sold or otherwise transferred by the taxpayer to any other taxpayer; and
- ?? delete the requirement that the taxpayer may not be related to any person growing the rice straw in California.

Policy Considerations

- ?? Credits are generally enacted with a repeal date to allow the Legislature to review its effectiveness. Deleting the repeal date, thereby permanently allowing the credit, reverses this policy of legislative review.
- ?? Credits for the purchase of property typically prohibit the acquisition of the property from related parties from qualifying for the credit. By deleting the related parties' prohibition, this bill would now allow a farmer to establish a separate business for developing rice straw products, sell the straw to a spouse, a son, a daughter, or other relative, and claim the credit. Further, this bill would allow the taxpayer to transfer/sell back the credit to offset other tax liability.
- ?? Generally, a tax credit is only allowed to the taxpayer that actually pays or incurs the related expense. The low-income housing credit is the only statute that specifically permits a credit to be transferred, but limits the transfer to a purchaser of the property. The state low-income housing credit may be transferred between affiliated corporations if the affiliation is 100% ownership, but this treatment merely gives the state low-income housing credit the same treatment as that provided under the federal consolidated return rules. This bill does not require any kind of affiliation between the taxpayer actually paying or incurring the expense and the taxpayer to whom the credit is transferred.

This bill would create a state tax law precedent by allowing tax credits to be transferred from the taxpayer that incurred the qualifying expenses to **any** other taxpayer (irrespective of whether such transferee is an affiliate). Thus, this bill would allow tax credits to be realized by taxpayers that did not incur the actual out-of-pocket expense on which the tax credits are based, thereby providing a benefit to one taxpayer for the action of another taxpayer.

- ?? Further, this bill essentially would create a system of "tax benefit transfers" similar to the old federal safe harbor leasing regime. Tax benefits transferable under federal safe harbor leasing rules were limited to tax credits and related deductions for the purchase of certain property, and the transfer was accomplished by a nominal sale-leaseback of that property in which the rights of the parties to the various tax benefits were clearly defined. Moreover, under the old federal safe harbor leasing rules, the federal tax treatment of the various forms of consideration flowing between the parties to the transaction were clearly defined.
- ?? Unlike the old federal safe harbor leasing regime, however, the transfer, sale, or assignment of the credit under this bill would not be limited to taxpayers who purchase rice straw; instead, the credits could be transferred, sold, or assigned to any other taxpayer. Further, this bill is silent on the tax treatment of the various forms of consideration that may flow between the parties to the transfer, sale, or assignment transaction. Thus, absent further legislative clarification, it is unclear how the payments made by the acquiring taxpayer would be treated for California tax purposes by both the seller/transferor and the purchaser/transferee of this tax credit.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation concerns:

- ?? This bill would allow the credit to be sold or transferred to any other taxpayer. The transferred credit could be applied against the net tax of the acquiring taxpayer in the same manner as would otherwise be allowed by this section. However, the bill, as amended, retains provisions of existing law that limit the credit to taxpayers that are an "end user" of the rice straw. An end user is defined as anyone that uses the rice straw for any purpose (other than open burning) that consumes the rice straw. It is unclear if the taxpayer acquiring the credit would be required to be an "end user" to claim the credit. Since the taxpayer acquiring the credit would not be the "end user" whose activities generated the credit, it is unlikely that the acquiring taxpayer would be eligible to claim the credit. Without clarification, this bill may not accomplish the author's intent. Further, neither the original taxpayer nor the taxpayer acquiring the credit is required to provide either the Department of Food and Agriculture, which must certify eligibility for the credit, or this department with information pertaining to the transfer of the credit. It is unclear how this department would implement this credit without such information.
- ?? This bill is silent on the proper tax treatment by the transferor and the transferee of the amount paid for the transfer or sale of the tax credit. It appears, because the bill does not state otherwise, that the transferor would include the amount received for the tax credit in income, and the transferee arguably could receive a business expense deduction for the purchase of the tax credit (assuming the purchaser was purchasing the credit in connection with a trade or business). In the absence of clarification, disputes may arise between taxpayers and the department about the proper tax treatment of the amount paid for the transfer or sale of a tax credit under this bill.

?? This bill leaves unclear when the transferee taxpayer first could use the transferred tax credit and the amount of the transferred credit that could be used. In the absence of specificity in the language, disputes may arise between taxpayers and the department about the timing of the use and amounts of transferred tax credits.

?? The bill does not address whether transfer of the entire unused tax credit would be required, or whether portions of the unused tax credit could be transferred. If portions of the unused tax credit could be transferred, the bill does not address whether or how one tax credit amount would be divided among multiple transferees.

?? If audit results modify the rice straw credit that has been transferred, assigned, or sold for consideration, it is unclear which taxpayer would be responsible for the additional tax from the audit adjustment. The bill should specify how the department would handle adjustments to the amount of the credit after the credit is transferred or sold.

Moreover, since the department's audit of the transferor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it may be necessary for the department to request a waiver of the unaffiliated transferee-taxpayer's statute of limitations. This would allow the department to adjust the transferee's tax liability if the department determines that part or all of the claimed credit should be disallowed.

Alternatively, if the claimed tax credit of the transferor is disallowed only in part, it is unclear how this disallowance would be allocated between the transferor and the transferee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

Furthermore, if the author's intent is to allow a portion of the unused credit to be transferred, then it is unclear how a disallowance of a portion of the credit should be allocated between the taxpayers.

Department staff is available to assist in the resolution of these and any other issues.

RICE STRAW STORAGE STRUCTURE CREDIT

This bill would create a rice straw storage structure tax credit equal to 50% of a taxpayer's cost for the construction of storage structures to house rice straw grown in California. Under both the PITL and the B&CTL, the maximum annual aggregate credit amount would be \$1.5 million for each calendar year. By reference to the Health and Safety Code, "rice straw" is defined as the dry stems of cereal grains left after the seed heads have been removed.

This bill would require the Department of Food and Agriculture to:

?? certify that the taxpayer has purchased the structures;

?? issue certificates in an aggregate amount that does not exceed the aggregate limit on a first come, first served basis;

- ?? provide an annual listing to the this department (preferably in computer-readable form and in a manner agreed upon by this department and the Department of Food and Agriculture) of the qualified taxpayers that were issued certificates;
- ?? provide the taxpayer with a copy of the certificate;
- ?? obtain the taxpayer's identification number or for a partnership or S corporation, the identification numbers of all partners or shareholders ; and
- ?? provide the Legislature with an annual informational report on or before each June 1 that includes the number of tax credit certificates requested and issued, the type of businesses receiving the tax credit certificates, and the cumulative total amount of rice straw that will be able to be stored with the new facilities.

To be eligible for this credit, **this bill** would require the taxpayer to:

- ?? provide the Department of Food and Agriculture with any documents it deems necessary to verify both that the structures were purchased by the taxpayer and that the structures meet the requirements of this provision. Taxpayers also would be required to provide their identification numbers, including all partners or shareholders identification numbers in the case of a partnership or S corporation;
- ?? retain a copy of the certificate issued by the Department of Food and Agriculture and provide the certification upon this department's request; and
- ?? agree in writing that the structure will be dedicated for the use of storing rice straw or rice straw harvesting or processing equipment for no less than 10 years.

In the event the storage structure for which this credit is allowed is not used to store rice straw or rice straw harvesting or processing equipment for 10 consecutive taxable or income years, **this bill** would require the credit to be recaptured by adding the credit amount to the taxpayer's net tax in the taxable or income year the storage structure ceased to be used as specified.

This bill specifies that the credit would be denied if the taxpayer fails to comply with these requirements, unless the taxpayer subsequently complies.

This bill would provide that a taxpayer may carry over any excess credit for the next 10 years or until the credit has been exhausted, whichever occurs first.

This bill specifies that no deduction or other credit shall be claimed for the purchase of storage structures for which another state tax credit has been claimed.

Policy Considerations

The 10-year "cliff" recapture period may be viewed as unusually harsh. A taxpayer that promises to use a structure for rice farming for at least 10 years, but after 9 years and 11 months is forced to abandon the venture, would be required to recapture the entire credit amount. Many recapture provisions are structured to allow partial earn-out of the credit. For example, the taxpayer could be required to recapture 100% of the credit if a recapture event occurs in year one, 90% of the credit if a recapture event occurs in year two, and so forth.

Implementation Considerations

Department staff has identified the following implementation concerns:

?? This provision appears to have internal conflicts. First, in subsection (a), this provision provides a credit for the *construction* costs of storage structures that will house rice straw. However, in subsection (h), this bill would require that the taxpayer agree in writing that the structure will be dedicated to housing rice straw or rice straw harvesting or processing equipment. Second, this bill requires the Department of Food and Agriculture and the taxpayer to certify the *purchase* of the storage structures rather than the *construction* of the storage structures. Further, this bill specifies that no deduction or other tax credit could be claimed for the *purchase* of structures for which a tax credit has already been claimed. However, it is silent on claiming a deduction or other tax credit for the *construction* of the storage structures. Clarification on both of these issues is necessary to properly implement this bill.

?? The taxpayer is required to agree in writing that the structure will be dedicated to the use of "storing rice straw or rice straw harvesting or processing equipment." "Rice straw harvesting or processing equipment" is not defined. It is unclear under the bill if rice straw harvesting or processing equipment used for any additional purposes, such as harvesting or processing another crop, would still qualify for the credit. Also, it is unclear what percentage of the storage structure would need to be "dedicated" to rice straw storage for purposes of this credit. Clarification of the terms "rice straw harvesting or processing equipment" and "dedicated" is necessary.

?? The recapture of this credit in the event the storage structure ceases to be used as specified would be impossible to administer as the provision is currently drafted. The department would have no way of verifying if and when the storage structure ceased to be used as specified.

Technical Consideration

Under the PITL and B&CTL provisions, in the event the storage structure is no longer used as specified, this bill would require the credit to be recaptured by adding the credit amount to "net tax." However, the B&CTL does not have "net tax," thus, this bill should be amended to add the credit amount to "tax."

FISCAL IMPACT

Departmental Costs

With the implementation concerns resolved, this bill should not significantly impact the department's costs.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, revenue losses from this bill are projected to be as follows:

Estimated Revenue Impact of AB 2514 As Amended June 26, 2000 For Years Beginning After December 31, 2000 (\$Amounts in Millions)			
Fiscal Years	2001/2002	2002/2003	2003/2004
Rice Straw Purchase Credit	Negligible	Negligible	Negligible
Rice Straw Storage Structure Credit	Negligible	Minor	-\$1
Revenue Impact (Rounded)	Negligible	Minor	-\$1

Note: Negligible means less than \$250,000; Minor is less than \$500,000.

Any possible changes in employment, personal income, or gross state product that might result from this provision are not taken into account.

Tax Revenue Discussion

According to departmental data for the existing credit, \$40,000 was claimed in rice straw credits for the 1998 year - 10% of credits permitted under current law allocations (aggregated limit of \$400,000 per year). From the estimated 1.86 million tons of rice straw produced in California during 1998, tax credits were claimed on only 2,700 tons (0.14% of total).

It is speculative to what extent the tax credits would provide meaningful incentives regarding rice straw usage. The estimates reflect the low level of credits claimed under current law for rice straw purchases and allow for a similarly low use level for the new storage structure credit exclusively for storage of rice straw or rice straw harvesting or processing equipment.

BOARD POSITION

Pending.